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Analyzing the Controversy Over the Federal Reserve System and Its Power

We live in a country with a very complex economy with a wide variety of transactions happening every day. Whether they're small or large transactions, from an economic point of view, they all represent the same thing: an exchange of ownership for a money—the U.S. dollar in this case. The management of the U.S. dollar is therefore crucial to our country. The Federal Reserve (Fed) is in charge of handling the money supply. It was created after past financial crises to develop a better control of the money and the country's economy in general. The Federal Reserve is run by non-elected bodies. Perhaps some questions may arise in minds such as the following: what is the Fed? What is its job? How does it manage to do it? Or How does it help the country's monetary system? These all are some of the questions we will be trying to bring light upon in this paper.

History is a great teacher. History gives us the possibility to look back and learn from one's own past actions and behaviors. Reflecting on the past can help us figure out ways to do things differently—perhaps better. It is even more important in economics. The complexity and high cost of conducting experiments in economics makes those experiments virtually impossible. So, economists and policy-makers rely on the past to make laws and decisions. The U.S. has also tried to learn from its economic past and improve. The United States has had series of financial crises before the creation of the Federal Reserve. Each one has brought more and more concerns and questions about the country's financial system. The panic of 1907 was certainly the most alarming. In "Panic of 1907," Wikipedia contributors write, "For a three-week

period starting in mid-October 1907, the New York Stock Exchange fell almost 50% from its peak the previous year. It was particularly alarming because it occurred when the country was already in recession. It spread throughout the whole country. Most states, local banks and businesses went bankrupt.” All these crises had the country rethink its monetary system which led to the creation of the Federal Reserve on December 23, 1913, with the enactment of the Federal Reserve Act by the U.S congress.

The Great Depression was the Fed’s first major challenge. In August 1929, the United States went into a recession—the worst of its history. In late October 1929, the share prices of the New York Stock Exchange collapsed. It was only then that people started to realize the economy wasn’t doing so well. People throughout the country were financially struggling due to the collapse of the banking system. In “Great Depression,” Holly Donald and Trescott Paull B, state, “At its [Great Depression] peak in 1933, unemployment stood at 12,634,000, more than 1 of every 4 people in the labor force.” It was an opportunity for the Federal Reserve to shine and show its potential. Unfortunately, many people argue that the Fed was in fact the root of this depression while many more are questioning the effects of its policies during this time of hardship for all the American people.

The Fed’s policies often didn’t turn out as effective as planned. During a period of emergency such as the Great Depression, decisions are needed to be made fast. The Fed had to react to changes in the banking system—often for the worst—with policies that would help redress the economy. In 1930, many banks in agriculture areas experienced bank failures. This pushed many people to withdraw their money from banks due to the fear of losing their savings and deposits. Thus, reducing the money multiplier and spending which can only stop economic

growth. The money supply fell by almost 30 percent, and the country experienced a deflation of the same magnitude. In “The Great Depression,” Gary Richardson states the following:

“The Federal Reserve could have prevented deflation by preventing the collapse of the banking system or by counteracting the collapse with an expansion of the monetary base, but it failed to do so for several reasons. The economic collapse was unforeseen and unprecedented. Decision makers lacked effective mechanisms for determining what went wrong and lacked the authority to take actions sufficient to cure the economy.”

So, the Fed’s decisions—lack therefore in this case—caused disproportionate consequences that are believed by many to be preventable.

Today’s US dollar is just a piece of paper. It has no intrinsic value, and it’s not backed by anything that one could possibly trade for. Its only value comes from our trust in the Federal Reserve. We use the dollar in our everyday transactions solely because the Fed claims it has value. It hasn’t always been always that way. For almost half a century, beginning in 1879, \$20.67 was worth an ounce of gold. That is, anyone with \$20.67 could redeem that money for an ounce of gold. This was known as the Gold Standard. In “What is Gold Standard,” Nick K. Lioudis, writes “The gold standard is a monetary system where a country's currency or paper money has a value directly linked to gold.” Anyone with dollars had the insurance of exchanging them for gold. That was until 1933, when Franklin D. Roosevelt urged Congress to move away from the Gold Standard in preference for a national currency.

During the period of the Great Depression, monetary expansion was believed to be a durable solution to the country’s financial problems. Increasing the money supply had to be followed with an increase in the gold reserves. This made a lot of monetary policy impossible or perhaps very challenging. In “Public Papers of The Presidents of the United States in 1934,” Roosevelt, states, “[T]he free circulation of gold coins is unnecessary, leads to hoarding, and

tends to a possible weakening of national financial structures in times of emergency[.]”

convinced of that, he signed the Executive Order 6102 on April 5, 1933. Thus, "forbidding the Hoarding of gold coin, gold bullion, and gold certificates within the continental United States". This Executive Order required all gold-owner to return the gold to Federal Reserve at a price of \$20.67—\$400 today—per ounce. The price of gold for international transactions was then raised to \$35 by the Gold Reserve Act of January 30, 1934. The result was an increase in the Federal Reserve’s balance sheet, while also reducing the export of gold from the United States.

Roosevelt had made it illegal for people in the United States to own gold or redeem dollars for gold, but not people overseas. That is, international dollars could still be converted to gold. Especially since the U.S. was part of the Western Bretton System—a monetary management establishing the rules for commercial and financial relations among the United States, Canada, Western European countries, Australia, and Japan after the 1944 Bretton Woods Agreement. In the early 70s, the United States was experiencing astronomic inflation. The dollar was depreciating against many foreign currencies. Gold was then more valuable than our currency. In order to stop the inflow of foreign dollars, Richard Nixon cancelled the international convertibility of the U.S. dollar to gold on August 15, 1971. Thus, making the U.S. dollar a fiat money. Today the dollar is only backed by the full faith and credit of the government.

It is no secret that the Fed has immense power. The Fed can make money out of nothing. As we have seen it, monetary expansion has been a solution to economic crises more than once in the United States. It is arguable that monetary expansion has helped stabilize the economy and improve a lot of Americans’ lives—at least for a short period of time. But saying

so would be looking at only one side of the coin. It has also been shown that an increase in the money supply without an actual increase in the level of production of outputs will always lead to inflation. Inflation is a funny thing; it makes anyone who holds money less wealthy without actually taking away any money. It raises prices of goods in the economy while people's income remains constant or increases but not proportionally to the level of Inflation. The result is a decrease in purchasing power for all the people in the economy. Thus, making them less wealthy.

So, not only the Fed has power to increase or decrease the quantity of money, it also can control the value of money. And a lot of people worry about this power. It can be scary to know that an entity can at any time alter the value of your money without any justification. That's one of the main reasons some would want to get rid of the Federal Reserve for alternative systems. A lot of people are now advocating for this cause. Ronald Ernest Paul—commonly known as Ron Paul—is a physician, author, and retired politician. He spent most of his political career fighting for the abolition of the Federal Reserve. In 2009, he wrote a book titled “End the Fed” in which he argues why the Fed is a danger and needs to be abolished. In “End the Fed,” Paul writes the following:

The Federal Reserve should be abolished because it is immoral, unconstitutional, impractical, promotes bad economics, and undermines liberty. Its destructive nature makes it a tool of tyrannical government. Nothing good can come from the Federal Reserve. It is the biggest taxpayer of them all. Diluting the value of the dollar by increasing its supply is a vicious, sinister tax on the poor and middle class.

It is obvious that Paul doesn't trust the Fed. He believes that our current monetary system is failing the poor and middle class. He argues that the Fed only benefits a private group while the

losses are paid for by the whole country. That's the reason why he believes that only a commodity-backed currency such as the Gold Standard can help our cause.

In conclusion, people's opinion about the Fed is divided—just like about anything else. Some argues that the Federal Reserve is vital for the prosperity of our country's economy. They believe it has helped stabilize the economy and the dollar in the last 40 years. They bring up circumstances which they believe the Fed saved the financial system and the economy in general. One of which is often is the Fed's monetary policies that helped stop the crises of 2007. While others are still skeptical about the fact that this much power is granted to non-elected bodies and believe that a central bank shouldn't be so manipulative and involved in the economy. As our central bank, the Fed has its cons and pros. Each side has some valid argument. There are evidences supporting both its pros and cons, deciding on whether the Fed is fit or not is a complicated matter. We shall see what the future holds for us, or rather our money.

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